

Challenges and Changes

The Global Financial Meltdown

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Whether you are an investor, borrower, manager, consumer or director, it is clear there are uncertain times ahead. Alan Greenspan, past Chair of the U.S. Federal Reserve Board recently suggested the current market conditions are a “once in a century credit tsunami.” He added “no one could have predicted the collapse of the housing boom and the financial disaster that followed.”

Yet, many are asking whether the fall of global capital markets should have been predicted by economists, corporate decision-makers or directors. With hindsight, perhaps we could have seen signs that would have led to different outcomes. However, I believe looking forward to how we can prevent worsening conditions is where focus is best placed now. Companies must be prepared both for worst-case scenarios and for potential opportunities.

A resource I recommend to help directors reflect on the situation is a *Director Alert* written for the CICA by Robert Adamson, LL.B. and Alan Willis, CA. This guidance piece provides a brief discussion of the current market situation and identifies key questions for directors to consider and discuss to better understand their companies’ exposure and their own obligations.

The Global Financial Meltdown: Questions for Directors to Ask

Companies around the world are being confronted by a perfect storm: frozen credit markets, a looming global recession, equity markets that have succumbed to panic and interventions by central banks and regulators. Not long ago, many argued that there was a new resilience in the world economy as emerging countries had decoupled from a reliance on the economic health of the U.S. But now there is growing evidence that world economies are more interconnected and symbiotic than anyone really understands. Moreover, events are moving so rapidly that it is almost impossible to assess the implications of the meltdown for the days ahead, let alone the years.

Canadian companies are not immune from this turmoil; they already face exceptional economic challenges:

- A volatile currency;
- Constraints on liquidity, credit and access to equity capital;
- Decreased demand from our largest trading partner;
- Fluctuations in energy and other resource prices;
- A regulatory environment that will inevitably change some of the rules of finance; and
- National economies around the world whose banking systems seem to be teetering on the precipice.

Yet, while these challenges may create negative business sentiment and pessimism, there may also be opportunities that some companies are well positioned to capitalize on. The key is to measure opportunities against significant and unknown risks.

What are directors to do in these uncertain and volatile times? Directors are encouraged to ask questions to understand what is happening and to ensure management is preparing corporations for what lies

ahead. These are not questions to which there will be immediate or easy answers. These are questions that try to assess what directors know and what they need to know in the following areas:

- The economic circumstances in Canada and the markets for a company's goods and services;
- Current and future constraints affecting liquidity and financial condition, in both debt and equity capital markets;
- The possibilities of collapsing deals and their implications;
- The likely impact that events will have on value of the Canadian dollar;
- What the regulatory environment will look like if new banking and finance rules are created in response to this crisis;
- The impact that all of these events will have on consumers and investors whose attitudes and sentiments will shape how this crisis ends; and
- The company's actions in response to the challenges set out above.

Some of these issues are short-term and demand immediate attention and reaction. A greater challenge, however, is predicting the long-term impact of the current crisis. The *Director Alert*, while discussing both, focuses more on the long-term – the forward-looking and strategic fallout that will confront companies and their management in the months and years ahead. It presents a series of questions that fall into four categories for directors to consider asking management or each other.

Uncertainty, Risk and Business Strategy

Business strategy and risk assessment need to focus on the possible implications of a wide range of current and forward-looking economic scenarios. Different economic scenarios - even extreme scenarios - should be contemplated, as well as how these scenarios can be worked into an enterprise-wide business strategy, one that addresses both risks and opportunities.

Directors should question the actions that have been taken by management in response to the operational and financial impacts of the global financial and economic meltdown:

- What are the most significant threats to our business?
- What have the operational and financial impacts been to date on the company as a result of the global financial and economic meltdown?
- In what ways are our current business strategy and our strategic planning assumptions affected by recent events and changes?
- Has management evaluated the implications of various scenarios?
- On what basis did management decide which scenario is the most appropriate for short term actions and long term planning purposes?

Consider the implications for matters such as:

- *Operations*: For example, sales and revenues, operating costs, inventories, interest and working capital.
- *Capital projects*: Both projects in progress and proposed or approved but not yet commenced.
- *Mergers and acquisitions*: Whether the M&A "game plan" needs to be reevaluated, or whether the company now is at greater risk of a hostile takeover.
- *Opportunities*: Whether the current financial turmoil has created opportunities for the company.
- *Political Environment*: Whether the political environment has changed in areas where the company has global operations, sells to consumers or relies on supply chains.

Financial Condition and Liquidity

It is likely that financial issues will have the first and most formidable impact on many Canadian companies. Financial capacity issues need to be considered in relation to their impact on business strategy.

The financial condition of many companies will be affected by constraints on liquidity and constrained and more expensive debt and equity capital. These in turn are likely to impact business operations or result in projects that cannot be financed as planned. Mitigating the impact of such constraints will become a priority. Here are some questions to consider:

- What is the timing of maturity on existing credit facilities?
- Does the company have sensitivities to currency fluctuations?
- Is the company sensitive to regulatory changes that may result from the financial crisis?
- What are the implications on the companies financing strategies if the equity markets continue to be volatile and negative and borrowing continues to be difficult?
- Are we able to meet the terms of existing debt? If not, will we be able to refinance as necessary?
- Do investors still have confidence in the company's stock?
- Is the company able to meet its pension fund obligations?
- Have the company's hedging and risk management strategies created problems or unintended consequences?

Reporting and Disclosure

Significant changes may also be on the way in the reporting and disclosure areas. Investors and consumers have lost some confidence in how the financial system works, and may have lost confidence in corporations and the transparency and integrity with which business is conducted.

Every company needs to consider whether its financial reporting, disclosure and other communications are adequate to meet the demands of investors, regulators, consumers and employees in order to maintain or restore confidence in the company.

It may even be necessary to consider and evaluate the premise that a company is a going concern – a fundamental accounting and reporting concept, in view of the recent collapses and bailouts.

Boards and directors need to be vigilant in ensuring that disclosures are neither deficient nor misleading in addressing crisis-related reporting issues. What is being done to communicate with investors, bankers and shareholders in these times of turmoil?

Disclosure issues that directors need to consider, especially in the MD&A, include:

- The effect of recent volatility on the company's results;
- The impact of banking disruptions on management of liquidity and the funding of operations and capital projects;
- The impact of significant uncertainty on accounting estimates embedded in items in the financial statements; and
- Revisions to disclosures about risks discussed in previous periods' MD&As.

Leadership and Corporate Governance

Finally, there are important governance issues that sooner or later will confront boards. Corporate governance practices are likely to come under greater scrutiny in response to concerns that existing governance practices may have made an already bad financial situation even worse. CEO and board selection and composition, executive compensation, risk management, focus on long-term value creation and shareholder activism will be among the many corporate governance issues likely to reverberate throughout the corporate world.

Directors will need to consider whether selection of the current CEO and CFO was based on qualities and skills perceived to have been appropriate to executing strategy under circumstances and assumptions very different from those we now face. Directors will also need to review whether the executive compensation structure needs to be adjusted in light of new business conditions and performance expectations.

Directors will also want to ask themselves questions such as:

- With hindsight, what signs might we have seen that could have caused us to respond differently?
- What might we learn and do differently in the future to be better able to predict and respond to imminent market and financial crises?

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